



HONG KONG MONETARY AUTHORITY
香港金融管理局

Our Ref: B1/15C
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14 March 2011

The Chief Executive
All Authorized Institutions

Dear Sir / Madam,

Enhanced Regulatory Requirements on Selling of Investment-Linked Assurance Scheme (ILAS) Products

In view of the popularity of ILAS products and their salient features and risks (including in many cases long tenor or lock-in periods), the Hong Kong Monetary Authority (HKMA) considers it necessary to further enhance the regulatory requirements for the sale of ILAS products by Authorized Institutions (AIs).

When selling ILAS products, AIs should ensure compliance with the relevant regulatory requirements¹, particularly the control measures set out in Annex. Most of these measures are existing regulatory requirements or practices generally adopted by the industry that are now being formalized as regulatory requirements to ensure their consistent application by all AIs to enhance investor protection.

AIs should review their existing control procedures and practices in the sale of ILAS products to ensure that they comply with the relevant regulatory requirements. The HKMA expects compliance with the control measures set out in this circular as soon as practicable. Where a control measure entails system changes, the HKMA expects full compliance with that particular measure no later than six months from the date of this circular. However, AIs should, as far as practicable, take prompt alternative measures in the interim, to implement the control requirements while system changes are being made. The onus is on the AIs to ensure that proper control measures are in place for the sale of ILAS products.

¹ Including, inter alia, “The Code of Practice for the Administration of Insurance Agents” and “Updated Requirements Relating to the Sale of ILAS Products following the Introduction of the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products” issued by the Hong Kong Federation of Insurers.

If you have any questions on this letter, please feel free to contact Ms Alice Lee at 2878-1603 or Ms Florence To at 2878-1582.

Yours faithfully,

Meena Datwani
Executive Director (Banking Conduct)

Encl.

c.c. Insurance Authority (Attn: Ms Carol Hui, Acting Assistant Commissioner of Insurance (Policy & Development))
SFC (Attn: Mr Stephen Po, Senior Director of Intermediaries Supervision)

Control Measures for Selling of ILAS Products

1. Competence of staff and registration

1.1 AIs and their staff who sell ILAS products should ensure that they are properly registered with the Insurance Agents Registration Board (IARB) of the Hong Kong Federation of Insurers (HKFI) as insurance agencies and technical representatives of the principal insurance companies (principal insurers) respectively before engaging in the relevant line of business.

1.2 In addition, it is incumbent upon AIs to provide sufficient training to ensure that staff engaged in the selling of ILAS products (i) have adequate knowledge and skills to provide explanations, recommendations or advice to customers about such products; (ii) are conversant with the selling procedures and relevant controls; and (iii) are aware of the relevant regulatory requirements that they need to comply with.

2. Product due diligence

Product approval and review

2.1 AIs should develop sufficient understanding of the nature and structure of ILAS products, including the underlying investments, the insurance protection, lock-in periods, fees and charges, penalty for early encashment, the credibility and capability of the insurance companies issuing the ILAS products, and other factors that may have an impact on the risk and benefit profiles of the ILAS products.

2.2 In accordance with the requirements set out in the HKMA Supervisory Policy Manual module IC-1 “General Risk Management Controls”, the independent risk management function should be involved in the product approval and review processes to ensure that the risks of ILAS products are well understood and adequately assessed. All relevant departments, e.g. risk control, legal and compliance, should be consulted as appropriate.

Product risk rating

2.3 It is incumbent upon AIs to conduct their own product due diligence² and not to merely rely on the risk assessment conducted by the issuing insurance company. In addition, AIs should perform a continuous review of the risk ratings it has assigned to the underlying investment options of ILAS products and make revisions to such risk ratings as appropriate. Where a review results in a higher risk rating, the affected customers should be notified through a monthly statement or a separate letter.

² For instance, the AI may conduct the product due diligence on an investment fund to serve the dual purpose of offering that fund as an underlying investment option of an ILAS product and as a separate mutual fund product.

Product tenor

2.4 AIs should assess and determine the tenor of an individual ILAS product, and match it with a potential customer's preferred investment horizon. In general, ILAS products are longer-term products designed to be held by the policyholder for a relatively long period (e.g. at least five years or above). AIs should take into account, among other things, the lock-in period (the period during which penalties or charges will apply in the event of early encashment) for determining the tenor of an ILAS product.

3. *Use of gifts*

3.1 To avoid distracting customers' attention from the nature and risks associated with ILAS products, AIs should not offer financial or other incentives (e.g. gifts) for promoting ILAS products. Discount of fees and charges, and the offering of any gifts for brand promotion, relationship building or other purposes not directly related to the promotion of ILAS products will not fall foul of this requirement.

4. *Selling activities to be conducted inside investment corner*

4.1 Pursuant to the HKMA circular of 25 March 2009, any solicitation, recommendation, discussion on ILAS products and sale of ILAS products to customers should be carried out only inside AIs' investment corners.

5. *Product disclosure*

5.1 AIs should make adequate disclosure to customers through proper explanation of the nature and risks of ILAS products, including, among other things:

- Product nature – AIs should make it clear to customer at the outset that the product is an investment-linked insurance product. ILAS products should not be misrepresented, for example, as savings plans or deposits, or investment funds without any insurance element. Both the investment and insurance elements should be properly disclosed. Any description that disguises the insurance element, e.g. describing ILAS as “investment funds with complimentary insurance or life protection”, is inaccurate and unacceptable.
- Investment options and risks – AIs should disclose and explain the nature and risks of the investment options under each ILAS product. AIs should make it clear, where applicable, that there is no guarantee of the repayment of principal.
- Credit risk – AIs should disclose the name of the insurance company, the fact that the premiums the customer pays will become part of the assets of the insurance company and that the customer will not have any rights to or ownership of the underlying investment assets, and thus he or she is subject to the credit risk of the insurance company.

- Insurance protection – AIs should disclose and explain the amount and/or the basis of determining the death benefit, including the fact that the amount is subject to the market risk and the foreign exchange risk of the ILAS product, where applicable, and that the death benefit payable may be significantly less than the premiums paid and may not be sufficient for the customer's estate planning purpose.
- Premium payment – AIs should disclose the amount, frequency and duration of premium payments. AIs should also explain the circumstances under which a premium holiday can be exercised and its consequence (e.g. the value of the ILAS product may be reduced due to the continuing fees and charges; the entitlement to loyalty bonus may be affected; and the ILAS product may be terminated and the policyholder may be subject to a surrender penalty if he or she fails to resume making the premium payments). Where the ILAS product allows policyholders to take out policy loans, AIs should disclose and explain how the policy loans operate (e.g. whether the loans will be automatically given when the policyholder does not pay a premium payment that is due), the interest and charges on the loans, and the possible termination of the ILAS when the account value is insufficient to cover the outstanding loans and accumulated loan interest.
- Lock-in periods – AIs should disclose and explain that ILAS products are designed to be held for a medium/long-term period and that early surrender of the product may be subject to a heavy financial penalty, and disclose the level of penalty. AIs should also explain to customers the restrictions on cash withdrawal, if any.
- Fees and charges – AIs should disclose and explain the fees and charges at both the scheme level and the underlying investment asset level, and that due to the fees and charges, the return on the ILAS product as a whole may be lower than the return of the underlying investment assets. AIs should also explain that part of the fees and charges paid will be used to cover the charges for the life insurance coverage. The insurance charges will reduce the amount that may be applied towards investment in the underlying assets selected. The insurance charges may increase significantly during the term of the ILAS product due to factors such as age and investment losses. This may result in a significant or even total loss of the premiums paid.
- Cooling-off period – AIs should draw to the attention of the customer his or her right to cancel the policy, how he or she may exercise the right and how the refund will be calculated.

5.2 AIs should provide to customers the ILAS offering documents and Product Key Fact Statements (if issued). When explaining or recommending ILAS products to customers, AIs should give balanced views. Where direct investment in the underlying investment assets (e.g. unit trusts and mutual funds) can be the alternative of indirect investment through ILAS products, AIs should explain to customers the

pros and cons of ILAS products compared with direct investment in the underlying investment assets and taking out a life insurance policy separately³.

5.3 As required by the HKFI, AIs must distribute the HKFI's education pamphlet entitled "Questions you need to ask before taking out an ILAS product" to potential policyholders of ILAS products at the point-of-sale. Where appropriate, AIs may also refer their potential customers to other ILAS-related public education materials, e.g. those issued by the Securities and Futures Commission or the HKFI.

6. *Ensuring customer suitability*

6.1 AIs should take all reasonable steps to ensure that the recommended ILAS product is suitable for a customer having regard to the customer's circumstances, such as investment objectives and horizon, investment experience, risk tolerance level, affordability and asset concentration, etc. In general, customer risk profiling and needs analysis should be performed prior to making any solicitation or recommendation in respect of any ILAS products. In this respect, AIs should ensure compliance with the HKFI's "Updated Requirements Relating to the Sale of ILAS Products following the Introduction of the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products".

6.2 AIs should follow the measures set out in the HKMA circular of 25 March 2009 in assessing a customer's risk profile. One of the objectives of these measures is to avoid exerting any undue influence on or the manipulation of the risk profiling result. AIs should guard against any acts, before, during or after the profiling process, that may defeat the purpose of these measures.

6.3 While ILAS products can take various forms, those currently available in Hong Kong mostly offer a wide range of investment options with varying risk levels which a customer can choose from. It is also a common feature of ILAS products that subsequent switching between investment options and a top-up investment are allowed. At the point-of-sale of ILAS products, AIs should explain to the customer the possible risks of switching to or top-up investment in investment options that are inconsistent with his or her risk profile. AIs should remind the customer to discuss with relevant staff before making a subsequent switching or top-up investment.

6.4 Where a customer indicates that he or she does not need/want insurance/investment products, AIs should not recommend ILAS products. Further, in view of the long lock-in period of ILAS products, AIs should ensure that due regard is paid to a customer's risk tolerance, financial situation, liquidity needs, investment horizon and retirement plan (if any) in considering whether ILAS products are suitable for him or her. In particular, when dealing with elderly customers or customers in need of liquidity, AIs should alert them of the lock-in period and ensure that the product is suitable for the customer. AIs should allow sufficient time for these

³ Disclosure of the conceptual pros and cons may suffice. It may not necessarily require a technical comparison involving actuarial information.

customers to consider the product or seek advice from their relatives or friends where necessary.

6.5 AIs should exercise extra care in selling investment products to vulnerable customers⁴. Among other things, there should be more than one front-line staff member handling the sale to such a customer, unless the customer opts out of this arrangement and proper audit trail is maintained on this opt-out decision.

6.6 More stringent control measures should be adopted for transactions involving a risk mismatch. Adopting the standards stipulated in the HKMA circular of 25 March 2009, whenever any of the investment options selected by a customer in an ILAS transaction has a risk rating higher than the customer's risk tolerance level, before accepting this transaction, the bank staff should (i) remind the customer of the risk mismatch and that the investment option(s) may not be suitable for him or her; (ii) document the reasons of any product recommendations as well as the reasons for the customer's choice of investment option(s); (iii) ensure the customer's acknowledgement of the risk mismatch; and (iv) appropriately audio-record the relevant conversation in respect of these arrangements. In the event of inconsistent answers given by the customer, the bank staff should seek clarification and document the reasons given by the customer. Endorsement should be sought from supervisory staff.

6.7 AIs should have proper audit trail, including audio-recording, of every switching transaction or top-up investment processed by the AI to capture either (i) the customer's acknowledgement that the switching or top-up investment did not involve solicitation / recommendation by the AI or its staff; or alternatively (ii) the rationale for any solicitation/recommendation by the AI or its staff. If the switching transaction or top-up investment processed by the AI involves the customer choosing risk-mismatched investment option(s), the control measures set out in paragraph 6.6 should also be adopted. Similarly, there should be appropriate warnings, alert messages and audit trail for transactions conducted through channels other than bank branches such as phone banking or Internet banking.

7. ***Records maintenance and audio-recording***

7.1 AIs should ensure that adequate records and an audit trail (including audio records) are in place to show that the proper selling process has been followed. AIs should ensure the salient parts of the sales process and ancillary arrangements relevant to the ILAS application are properly audio-recorded. This should cover the salient parts of the customer risk profiling, relevant information for suitability assessment obtained from financial needs analysis⁵, provision of alternatives and rationales of the recommendation (e.g. covering why the ILAS product was recommended instead of

⁴ Examples of vulnerable customers include (i) the elderly (aged 65 or above); (ii) visually impaired; (iii) illiterate or those with low education level (primary or below); and (iv) those who have limited means and/or no regular sources of income.

⁵ The audio recording need not capture the entire FNA but, at the minimum, should capture the customer's answer to each question of the financial need analysis form relevant to the customer's suitability in respect of the ILAS product.

direct investment in funds and separate life insurance policy), disclosure of product features and risks, Applicant’s Declarations, and Customer Protection Declaration.

8. Management oversight

8.1 AIs should have adequate management oversight of the sale of ILAS products. AIs should establish proper management information system (MIS) reports for management to assess its business and identify risks or non-compliance. High risk areas and exceptions (such as transactions with vulnerable customers, tenor and/or risk mismatch transactions, affordability issues or high asset concentration) related to the sale of the ILAS products should be monitored. There should also be regular independent reviews of the selling process of ILAS products, covering test-checks of ILAS transactions including those identified as high risk areas and exceptions. The “mystery shopper” programme of AIs should include a test of the ILAS product selling process. Appropriate follow-up actions should be taken if any irregularity is identified.

9. Complaints handling

9.1 AIs should ensure that complaints relating to ILAS are handled in a proper and timely manner, in accordance with the HKMA Supervisory Policy Manual module IC-4 “Complaint Handling Procedures”. AIs should report to the relevant principal insurers all complaint cases and keep the insurers informed during the complaint handling process, as appropriate. Given the principal-agent relationship, the complaints may also be handled by the principal insurers and reviewed by the Office of the Commissioner of Insurance or the HKFI.

10. Notifications to regulators

10.1 AIs should promptly report to the HKMA and other relevant regulator(s) any material breach, infringement of or non-compliance with any applicable law, regulations and codes.

11. Disciplinary proceedings

11.1 Disciplinary proceedings under the Banking Ordinance may be taken against a relevant individual (ReI)⁶ if his or her conduct in the sale of ILAS products raises concerns about his or her fitness and properness to be an ReI. AIs should clearly communicate to all ReIs involved in the sale of ILAS products the potential risk of disciplinary proceedings being taken against them for any acts or omissions that raise concerns about their fitness and properness to be an ReI.

⁶ “relevant individual” refers to an individual registered with the HKMA by virtue of section 20(1)(ea) of the Banking Ordinance.

11.2 Similarly, disciplinary proceedings may also be taken by the IARB against technical representatives for non-compliance or misconduct under the Code of Practice for the Administration of Insurance Agents issued by the HKFI. AIs are advised to report, vide their principal insurers, to the IARB any disciplinary proceedings taken on an ReI for any acts or omissions that raise concern about his or her fitness and properness to remain as an ReI.

Hong Kong Monetary Authority
14 March 2011